

Internal Revenue Service
memorandum

CC:TL:Br2
SJHankin

date: JUL 22 1988

to: District Counsel, Manhattan

CC:MAN

from: Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This responds to your request for technical assistance, dated July 7, 1988, with respect to the following matter.

ISSUE

How should the Government respond in the above-named case to the taxpayer's argument: that a loss realized by [REDACTED] on the retirement of debentures issued by its wholly-owned subsidiaries is not deferred under Treas. Reg. § 1.1502-14(d)(1)?

LAW

Subparagraph (1) of paragraph (d) of Treas. Reg. § 1.1502-14 provides, as follows:

(d) Gains and losses on obligations of members --
(1) Deferral of gain or loss. To the extent gain or loss is recognized under the Code to a member during a consolidated return year because of a sale or other disposition (other than a redemption or cancellation) of an obligation of another member (referred to in this paragraph as the "debtor member"), whether or not such obligation is evidenced by a security, such gain or loss shall be deferred.

DISCUSSION

The above provision assumes that one member of a consolidated return group has recognized a loss from a sale or other disposition of an obligation of another member of the same consolidated return group. Based on such premise, the provision then provides that the reporting of such a realized and recognized loss is to be deferred, except where the disposition constitutes a redemption or cancellation of the obligation. In the instant case, the debenture obligation was redeemed, so the

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taxpayer is correct that the deferral rule of Treas. Reg. § 1.1502-14(d) would be inapplicable. Yet, as the Government's proposed Memorandum of Law for this case points out the above contention merely begs the question of whether any loss was realized (created) from the redemption of the debenture. If there is no loss created then the question of whether such loss should be reported or deferred becomes a moot one. In the instant case, the Government's position is that no loss was realized (created), because [REDACTED]'s basis in the nonconvertible debenture did not exceed the amount [REDACTED] realized on the redemption of the debenture. Accordingly, the Government's position does not rely on Treas. Reg. § 1.1502-14. Moreover, if a loss would have been realized by [REDACTED] on the redemption, we would agree with the taxpayer that the reporting of such loss would not be deferred by an application of Treas. Reg. § 1.1502-14(d).

Although we generally agree with the United States Attorney's discussion on page 21 and 22 of her Memorandum of Law, regarding the application of Treas. Reg. § 1.1502-14(d) to this case, we believe that such discussion contains a couple of errors. One, the last sentence of Page 21 of the US attorney's Memorandum of Law states that [REDACTED] is contending that it experienced a loss when it converted the debentures. [REDACTED] is not contending that it experienced a loss on the conversion, but rather that it experienced a loss upon the retirement (redemption) of the debentures. Two, the last full sentence on P. 22 of her Memorandum of Law states that [REDACTED] experienced no loss because its basis in the debentures was the fair market value of the [REDACTED] stock issued for the debentures. This statement is totally contrary to the position that the Government should be taking in this case. If the Government admits that [REDACTED]'s basis in the nonconvertible debentures was the full fair market value of the stock issued, it would automatically follow that [REDACTED] did realize a loss on the retirement of the debentures. Accordingly, such statement should be replaced with a statement that [REDACTED]'s basis in the debentures, for purposes of determining gain or loss on the redemption of the debenture, is not the total fair market value of [REDACTED] stock issued at the time of the conversion, but rather the principal (face value) of the debenture.

Additional Comments on the US Attorney's Proposed Memorandum of Law with Respect to the Convertible Debenture Issue

. We recommend that the proposed Memorandum of Law be redrafted, because it is based on a misconstruction of what taxpayer is arguing. Taxpayer is not asserting that it is entitled to a loss on the conversion ([REDACTED]'s issuance of its [REDACTED] stock in exchange for the outstanding convertible debentures). Rather, taxpayer is contending that it has realized a loss on the

retirement of the debentures. The US attorney's Memorandum in many parts is addressed to a loss on conversion, while in other parts it is addressed to a loss on redemption. The Memorandum is also faulty in that it gives the reader the impression that this case turns on what is the nature of a convertible debenture. Furthermore, the Government's capital contribution argument can be made whether the debenture being redeemed is considered a new debt or a continuation of the convertible debenture (i.e., a "converted" debenture).

The real issue in this case is what is [REDACTED]'s basis in the debt (be it considered an old continuing debt i.e., the "converted" debenture, or a new debt) for purposes of determining its gain or loss on the retirement of that debt. That basis amount can only be determining by looking at the previous conversion transaction. In that transaction [REDACTED] issued [REDACTED] stock in exchange for the outstanding debentures and pursuant to a prior agreement cancelled the conversion feature. This effected a net capital contribution by [REDACTED] to its subsidiary to the extent that the fair market value of the [REDACTED] stock issued exceeded the face value of the debt owed to [REDACTED] by its subsidiary. Hence, [REDACTED]'s basis in the debt following the conversion-capital contribution transaction is the principal (face) value of the debt. The excess uncompensated value paid out by [REDACTED], in the form of [REDACTED] stock, upon the conversion is the amount of the capital contribution by [REDACTED] to its subsidiary. As such, the excess cost basis attributable to that capital contribution should be added to [REDACTED]'s basis in its stock in that subsidiary, instead of being added to [REDACTED]'s basis in the debt owed to [REDACTED] by its subsidiary. The lynchpin of the Government's analysis is that [REDACTED] made a capital contribution to its subsidiary in an amount equal to part of the value of the [REDACTED] stock it issued to the debenture holders.

If one looks at the conversion and subsequent debt retirement together, it becomes clear that [REDACTED] has not suffered a loss. Rather, it has done something for the benefit of its subsidiary. That is, it has effectively satisfied an obligation, of its subsidiary. In exchange for satisfying that obligation, [REDACTED] receives only a right to an amount equal to the face value of the original debentures. The question then is why would [REDACTED] pay out a greater value (the fair market value of all the [REDACTED] stock it issued upon the conversion) than it has agreed to eventually receive, i.e., the face amount of the debentures. Clearly, the excess value paid out by [REDACTED] to the debenture holders was done to benefit its subsidiary and as such is a capital contribution by [REDACTED] to its subsidiary and not a deductible expense or a loss incurred through the holding and disposing of an investment i.e., the debenture. Who would invest in something where a loss is

predetermined from the start? Yet, that is the implication of [REDACTED]'s position that it has realized a loss on the retirement of these debentures.

We recommend that the above discussion form the basis for the Government's Memorandum of Law for this case.

After such generalized discussion, the Government should explain in its Memorandum that its capital contribution theory is applicable to this case regardless of whether the conversion transaction is viewed: (1) as [REDACTED] satisfying the entire convertible debt obligation and deemed as receiving a new nonconvertible obligation in the same face amount as the old debenture from its subsidiary as partial compensation for satisfying the subsidiary's convertible debenture obligation ("New Loan Approach"), or (2) as [REDACTED] acquiring the outstanding debentures as a continuing debt instrument ("converted debenture") which is then devoid of its conversion feature (i.e., this is the converted debenture approach, which we previously referred to as the nonconvertible debenture approach.

Although the "new debt" approach is our preferred approach as being the most theoretically consistent with the true nature of a convertible debenture, the "converted" debenture approach is supported by case law which adopts the notion that where a parent corporation issues its stock pursuant to the conversion right of a convertible debenture holder it acquires the debenture as a continuing debt obligation of its subsidiary that is then devoid of its conversion right. See, Husky Oil Company v. Commissioner, 83 T.C. 717 (1984); Honeywell and Subsidiaries v. Commissioner, 87 T.C. 624 (1984).


Under either of the above approaches, [REDACTED]'s basis in the debt (be it new debt or a continuing debt) owed to it by its subsidiary is the face value of the debt. Under the new debt approach a capital contribution is effected through [REDACTED]'s satisfaction of its subsidiary's convertible debenture obligation. The net amount of that capital contribution is the total value of all the [REDACTED] stock issued less the amount of the new obligation [REDACTED] is deemed as receiving from its subsidiaries as partial compensation for satisfying its subsidiary's convertible debenture obligation. Under the converted debenture approach, when [REDACTED] is called upon to satisfy the debenture holder's conversion right it is viewed as being called upon to assume and satisfy its subsidiary's conversion obligation (as if such obligation could be considered as separate from the underlying debt obligation) while the subsidiary is viewed as remaining liable to [REDACTED] on the continuing "converted" debenture obligation. As such, the assumption and satisfaction of the conversion obligation represents a capital contribution by [REDACTED] to

its subsidiary to the extent that the value of all the [REDACTED] stock transferred on the conversion exceeds the principal value of the debentures.

The Memorandum's discussion of the true character of a convertible debenture is correct but its only importance is to convince a court that the Government's new debt approach is the correct theoretical approach. As such, it should be incorporated into the explanation of the "new debt" approach and left out of the explanation of the "converted debt" approach.

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